

# **The East Asian Financial Crisis: Some Lessons For Uganda<sup>1</sup>**

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## **Abstract**

This think-piece briefly reviews the on-going Asian financial crises with a view to suggesting lessons for Uganda as it develops its financial system. Several policy reforms are identified as crucial to minimising the risk of financial crisis in Uganda. Strengthening banking supervision and ensuring that institutions responsible for macroeconomic monitoring and management are independent of government will minimise moral hazard risks that have been evident in previous bank insolvencies in Uganda. More generally, the investment environment should be transparent and fair, so that disputes can be settled and economic agents can make rational decisions based on commercial logic. This will help to build confidence in Uganda and reduce the likelihood of sudden shifts in investor sentiment. On external policy, Uganda should avoid targeting the nominal or real exchange rate given the inherent risks for such a policy in a regime of a fully liberalised capital account.

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<sup>1</sup> The views expressed in this paper are those of the authors and do not necessarily reflect the views of the Bank of Uganda. The authors are responsible for any errors and omissions.

## **1. Introduction**

There have been two regional emerging market financial crises in the 1990's; the first in Latin America which began in Mexico in December, 1994 and more recently in East Asia, which began in Thailand. Although both crises began with speculative attacks on fixed exchange rates, the underlying causes in the both have been similar in some ways and very different in others. For example, whereas Mexico had a high budget and current account deficit to GDP ratio prior to the speculative attacks, most of the East Asian economies (except Thailand) had modest and by consensus opinion (at the time) sustainable deficits or even surpluses before their currency pegs were tested. The East Asian economies also had a good record on inflation prior to the crises. This suggests that the next financial crises can potentially be very different. Therefore, while some lessons from the East Asian and Latin America crises may apply to Uganda, there are potentially new dangers that the authorities must be alert to.

This think-piece briefly reviews the on-going Asian financial crises with a view to suggesting lessons for Uganda as it develops its financial system. Attention is also paid to the structural differences between Uganda and the East Asian economies and how this makes Uganda vulnerable to new as yet undiscovered threats to the stability of its financial system.

## **2. Moral Hazard And Implicit Government Guarantees**

The issue of moral hazard in the East Asian banking and corporate sectors has featured prominently in explanations of the East Asian financial crises. Although in most instances governments did not provide explicit guarantees to domestic and foreign borrowings made by the corporate sector and to the lending practices of the banking sector, some analysts have suggested that press reports and the close informal relationships between politicians and these entities gave such an impression. There are many examples to go by. For example, in Indonesia many conglomerates had close links with President Suharto, and in South Korea the Chaebol were in many cases partly owned by commercial banks that were on-lending to these same institutions. This gave the impression that the debts were publicly guaranteed because the political establishment would not allow them to fail. In Korea this meant that the chaebol were able to borrow cheaply to expand capacity in markets such as semi-conductors, even though low returns (by international standards) would not justify such investments. Such decisions were a symptom of the moral hazard that is expected when an entity faces potentially unlimited gains if a decision is proven to be good, but faces a limited downside risk if things go wrong. The result is a distortion to incentives affecting investment decisions and lending practices of commercial banks.

The experience of East Asia has demonstrated that close links between the executive and business and banking can lead to a distortion of incentives and consequently, poor commercial decisions. In Uganda, links between commercial banks and political authorities, either in the form of private interests of parliamentarians or public

government ownership of specific businesses, are potential sources of distortions to incentives (moral hazard). This is the case if commercial managers and decision makers assume that they are guaranteed by government in the event that they may become insolvent.. Indeed, there exist examples of such root causes of bank insolvency in Uganda. For example, close links between the management of Uganda Development Bank and politicians resulted in loans that would not otherwise have been made on the basis of commercial logic. The situation continued until insolvency threatened and a strict programme of restructuring and capitalisation was instituted, together with a programme to recover outstanding loans.

There is potential for moral hazard behaviour in several other financial reforms that Uganda is currently implementing. The government is in the process of restructuring and bringing back to health its domestic banking industry. This has called for the privatisation of the largest commercial bank UCB, but only after it was recapitalised and a substantial proportion of non-performing assets taken off its books. While such policies are necessary, they need to be carefully structured and implemented so that they do not form either an explicit or implicit guarantees. Indeed, the present restructuring programme, from which some banks are now benefiting, should not set a precedent for automatic rescue of insolvent banks in the future - it should be case-by-case and based on commercial principles, with a view to averting a systemic banking crisis.

The deposit insurance scheme is another issue which needs to be carefully formulated to provide for maximum protection to depositors resulting in confidence in the banking system without leading to errant lending practices. Each commercial bank should pay an insurance premium to be part of the scheme, which would reflect the relative size and risk of its balance sheet as part of the whole banking system. Such a risk-weighted insurance premium is supposed to encourage more risky banks to strengthen their credit rating and lending procedures in order to reduce the overall risk of their balance sheets.

On a global level, another source of moral hazard exists. In the case of Mexico, the US Treasury was ready to lend massive bail out funds if and when necessary. The IMF has also been a large provider of bail-out funds. These bail-outs have demonstrated that foreign creditors are partially insured when an economy is unable to meet its foreign obligations. Therefore, the bail-outs can distort future lending decisions because of the downside risk to potential losses. This risk has to be weighed against the primary role of such bail-outs which is to build confidence in an economy facing a large sudden flight of capital. If the bail-out promise is successful and confidence returns, most of the bail-out funds may not be required. Based on the successful US intervention in Mexico in 1994, some have suggested that regional groupings that pool resources into a fund for future bail-out assistance may reduce the incidence and vulnerability to financial crises for member countries. However, as has been explained previously, the pooling of resources can create moral hazard behaviour. In conjunction with such a fund, it is necessary to have effective monitoring of economic developments in each country and to take action against those that demonstrate moral hazard behaviour.

### **3. Fixed Exchange Rates**

Fixed exchange rates compounded the moral hazard problem in East Asia. High domestic interest rates encouraged the private sector to borrow cheaply from abroad at US dollar rates which were far lower. Both (foreign) creditors and borrowers perceived the exchange rate link to be credible, at least for the life of their contracts. Therefore, the interest rate on foreign borrowing by East Asian corporations did not reflect the “true” exchange rate risk, while the assumed implicit guarantees also distorted the pricing of credit risks. This was reflected in historically low and falling spreads between the interest rate on US Treasury bonds and those on East Asian corporate debt.

Uganda has a floating exchange rate and so the mis-pricing of exchange risk is not likely to feature in the decisions of foreign investors to bring resources into the country. The recent sharp depreciation in the Uganda Shilling-US Dollar exchange rate of 6% over a period of three weeks highlights the exchange rate risks inherent in investing abroad. The experience of East Asia, and limited reserves at the Bank of Uganda make any policy to target the exchange rate very risky and potentially costly if it is non-credible and unsustainable.

#### **4. Banking Supervision And Disclosure of Information**

In the presence of distortions to incentives resulting from moral hazard, there is a greater need for professional and sound banking supervision. Monitoring of activities is crucial in revealing early warnings of weakening balances sheets resulting from poor lending practices. Indeed, the objective of bank supervisors is to ensure that such lending and borrowing practices are not accommodated in order to avoid bank collapses in the first place.

In East Asia, the regulation of banks and in general, the disclosure of information was inadequate. In Thailand, for example, banks were heavily exposed to the property sector. Having lent a substantial amount of their resources to property developments, Thai banks were vulnerable to property price deflation. Even after property prices began to fall regulators were willing to classify some loans as performing long after they had become non-performing by international definitions. This reveals both the inadequate implementation of banking regulations and the mis-leading or untimely disclosure of financial information. Consequently, investors had only a limited picture of the health of some institutions.

Uganda’s authorities have recognised the need for sound banking regulation as it nurses its banking industry back to health. More resources are being channelled into the development of financial regulation to include non-bank financial institutions and the institutions that implement these regulations. This is crucial since non-banks are likely to play an increasing role in the flow of financial resources as a wider range of financial instruments and services develop to meet the needs of customers, which no doubt will become more sophisticated. An increasingly sophisticated set of laws will require Uganda to build capacity to implement such new laws. Therefore, a strengthened and more efficient judicial system should complement the reform process being undertaken in the banking supervision system. The institutions responsible for banking supervision should be independent and resist attempts at politic influence, and make decisions based on the regulatory framework and the law.

Only then will they be credible and be able to build confidence in the financial system.

More generally, what is required is an open and transparent investment regime which provides for a level playing field for all potential investors (domestic and foreign) to be able to make informed judgements about where to channel resources. For this reason, Uganda needs to develop systems for disseminating financial information so that investors are well informed. The development of a stock exchange should encourage public listings with equity providing a new alternative source of financing. It is usually the case that a company is exposed to increased monitoring and scrutiny once it is listed because widely dispersed shareholders demand analyses (often at a fee) of the stocks they are holding in their portfolios.

## **5. Transparency in Macro-Economic Policy**

Transparency in national economic policy-making can help to avoid macroeconomic shocks caused by unanticipated policy changes that lead to abrupt shifts in investor expectations and sentiments.

Uganda has made substantial progress on this front. The government budget is published annually in the Policy Framework Paper and the Cash Budget system exacts significant discipline on fiscal policy and provides for easier monitoring of fiscal operations. The Bank of Uganda Statute 1993, provides for substantial autonomy in the management of monetary policy. The IMF, under the ESAF programmes, acts as external agent of restraint ensuring sound macroeconomic policy-making. An IMF seal of approval of the macroeconomic programme can enhance investor confidence within a country such as Uganda. But in the longer-term, improvements in the administrative capacity of the civil service and more public accountability in all activities of the executive will enhance the credibility of economic policy making. In addition, capacity building in domestic institutions are necessary to put Uganda on an independent footing in which sound economic policies continue to be formulated, implemented and monitored without external assistance.

## **6. Capital Account Liberalisation**

All the East Asian economies presently experiencing financial turmoil had fully liberalised their current and capital accounts. The potential benefits from the free movement of capital include the ability to augment domestic saving with foreign savings to fill the savings-investment gap, especially for an emerging economy that is rapidly developing its infrastructure and utilities which, in Uganda, require urgent improvement. However, while capital can freely enter an economy under such a regime, it can also leave very rapidly. This danger exists with inflows of short-term capital that may be speculative in nature. Chile, for example, has imposed selective controls on the inflow of some types of short-term capital. Since the financial crises in Latin America and East Asia, there have been increasing calls for emerging market economies to adopt selective controls on short-term capital. However, in Uganda, the lack of disaggregated data on capital inflows makes it difficult to identify selective controls on specific capital inflows that would reduce Uganda's vulnerability to a reversal of short-term capital inflows without acting as a dis-incentive and a cost on desirable long-term inflows.

To some extent, the liberalisation of the capital account in Uganda has made the task of monitoring disaggregated capital flows more difficult. Presently, banks are required to supply a monthly breakdown of foreign exchange purchases and sales. In recent years, private transfers have grown rapidly from 2% of GDP in 1990 to 7.3% of GDP in 1996. Some of this inflow represents Foreign Direct Investment which are based on a long-run assessment of the expected economic fundamentals and general investment environment in Uganda and are unlikely to precipitate a crisis. However, as yet, we do not have a clear impression of the composition of private transfers in Uganda and what proportion represents short-term inflows.

Given the short track record for macroeconomic stability and the infancy of its reform process, Uganda may be more susceptible to changes in investor perceptions.

## **7. Official Capital Flows**

Official flows from multilateral institutions, donor loans and grants continue to dominate the total amount of capital flowing into Uganda - in 1996 they amounted to 7.8% of GDP. These flows are intended to support Uganda's macroeconomic framework, and by their very nature, are unlikely to be reversed suddenly so long as Uganda continues to maintain sound macroeconomic management. Unlike private capital flows that can be withdrawn during periods of a crisis of confidence, official flows are subject to political negotiations and understandings. However, official flows are expected to fall over the medium term as a percentage of GDP. It is over this period that Uganda aims to become less reliant on official lending, and open up its financial system and attract foreign investment capital. This will be done through a combination of developing markets such as a market for secondary trading of government securities, investment vehicles and an equity trading market, in an environment of sound macroeconomic management.

The expected change in the mix of private versus official capital inflows poses some risk to the financial system in Uganda. Most official aid is intermediated by government agencies, but as the share of private capital inflows increase both absolutely and as a share of total inflows to Uganda, it is the private sector, especially the banking system, that will take on this role. For this reason, all the risk factors previously mentioned will have to be addressed. The role of government will increasingly be to facilitate an open and transparent investment environment and timely information dissemination, with a disciplined approach to financial regulation and macroeconomic policymaking and management.

## **8. Early Warning Indicators**

Data limitations and the long lags with which some of it is available, reduces the breadth of early warning indicators of financial crisis that may be available in Uganda. For example, private sector foreign currency indebtedness which has been highlighted in the East Asian crisis is not available in Uganda. The most promising variables available are the the current account to GDP ratio, the real effective

exchange rate relative to some notion of an equilibrium real effective exchange rate and a measure of domestic liquidity conditions.

## 9. Some Concluding Lessons

In light of the discussions above, it is useful to summarise the main lessons that Uganda can learn from the financial crises that have been observed to date, and to suggest possible actions to reduce the likelihood that financial crises will occur in Uganda.

- A high level of **foreign reserve cover** in terms of months of import of goods and services will help to build confidence in the Ugandan economy, thereby encouraging foreign investment. However, high foreign reserve cover is unlikely to prevent a crisis once confidence has evaporated.
- Targeting a nominal or real exchange rate should be **avoided**, especially in a regime of a liberal capital account in which capital can flow out suddenly.
- A **strengthened bank supervision** structure is required to monitor the behaviour of the banking system. The institutions responsible should be independent of political interference to ensure integrity and credibility in the regulatory framework. This will build confidence in the banking system and help minimise the moral hazard problem.
- Economic policy-making should be **transparent and accountable**. This will ensure that economic agents are well informed, helping to avoid sudden shifts in investor sentiment that are caused by unanticipated government action. As part of this process, it is necessary for Uganda to build internal agencies of restraint to ensure sound economic policy-making continues after external financing from agencies such as the IMF is no longer required. This also enhance confidence in the investment environment which should have an open and fair system to settle disputes.